

Lessons Learned - Contract Clauses to Include in Every Sole Source Supply Agreement

When supply is curtailed, or the supplier ceases to offer the materials for sale, what rights do you have?

Manufacturers are increasingly seeking ways to manage risks arising from a sole source supply of critical raw materials. Many buyers make the mistake of relying on the "*business relationship*" with the supplier to manage this risk. But, when the supply ends or is curtailed, the buyer often finds that it is one of many buyers in the same predicament, each having the same expectations of continued supply.

The foresight of the procurement manager to include protective language in the supply contract at the outset (when the bargaining power is in the company's favor) may make the difference between doing business as usual or shutting down the plant.

Here are three (3) mitigation clauses to consider in your next contract renewal.

Mitigation Clause #1: Business Continuity Plan

The predictability of continued supply of critical materials is largely based on the supplier's exposure to internal and third party threats to the supplier's supply chain. As part of the supply contract, the buyer should require that the supplier provide or develop a Business Continuity Plan (BCP) that demonstrates business continuity management capability, and delineates the prevention and recovery of threats that may interrupt or negatively impact supply. Prevention efforts may include having the supplier implement risk mitigation inventory and/or safety-stock of supplier's raw materials/sub-assemblies, or in critical applications, flow down protective contract provisions to the supplier's suppliers. The BCP should be periodically updated and approved by the buyer, and changes in circumstances which may materially affect supply should be promptly communicated to the buyer, and a plan for resolution should be implemented.

Mitigation Clause #2: Rights on Cessation of Product or Bankruptcy

Many supply contracts are devoid of provisions which



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contemplate the party's rights in the event the supplier decides to cease the supply of a certain product or is unable to supply a product due to insolvency. At a minimum, the supply contract should include a period of advance notice before the supply of a critical material is voluntarily discontinued. Similarly, the contract should include prompt notice if the company becomes insolvent, makes an assignment for the benefit of its creditors, or is subject to voluntary or involuntary bankruptcy proceedings.

In addition to notice, for non-perishable critical raw materials, the buyer may consider requiring that the supplier sell, and allocate to the buyer, a disproportionately large shipment of raw materials that the company may then hold in stock until an alternative source of supply is established. Additionally, the buyer may (particularly in the case of bankruptcy) require that the supplier provide the buyer with the recipe and production procedure (and associated licenses) to enable the buyer to manufacture or have the materials manufactured by a third party.

Mitigation Clause #3: Most Favored Nations

To ensure the continued supply of materials, the buyer may require the supplier to first allocate its materials to the buyer's account, or in some cases, allocate the supplier's resources (facilities, supplies and labor) to the buyer, before making an allocation of those materials or resources to the supplier's other customers.

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The bottom line is that it is often too late to negotiate for a favored allocation of supply after the supply is curtailed by an intervening event. The prudent buyer will have a frank discussion of these issues with the supplier at the time of contract renewal when the risk of a curtailment appears low, and the benefits of a renewed contract are real. Once the provisions are negotiated into the contract, it is likely that the provisions will remain in the agreement as part of future renewals as a matter of course. Including some or all of these contractual mitigation clauses in your next renewal may result in significant benefits to the company long term, and additionally, set a precedent for negotiations with future suppliers.

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